CONOCO, INC.

IBLA 86-1513 Decided May 31, 1989

Appeal from a decision of the Director, Minerals Management Service, upholding a decision of the Chief, Royalty Valuation and Standards Division, Royalty Management Program, Minerals Management Service, setting forth the transportation allowance formula to be applied to royalty-in-kind oil sold under Sale 83-1. MMS-0011-OCS.

Affirmed.

1. Administrative Procedure: Administrative Procedure Act--Administrative Procedure: Rulemaking--Oil and Gas Leases: Royalties--Outer Continental Shelf Lands Act: Oil and Gas Leases

Under the regulations then in effect, a transportation allowance formula issued by Minerals Management Service fixing the rate of return on undepreciated investment to be included in the formula is not subject to the notice and comment provisions of 5 U.S.C. | 553(b) (1982).

2. Oil and Gas Leases: Royalties--Outer Continental Shelf Lands Act: Oil and Gas Leases

Under the regulations in effect at the time that the transportation allowance formula was adopted, the Secretary of the Interior had discretionary authority to determine the factors to be considered when computing transportation allowances for royalty valuation purposes. When it is shown that the Minerals Management Service applied a formula which had been developed after appropriate research and consultation with affected oil companies and the appellant does not provide convincing evidence that a 8-percent rate of return on the undepreciated investment used in the formula was unreasonable, the transportation allowance will be upheld.

APPEARANCES: R. Carol Harvey, Esq., for Conoco, Inc; Peter J. Schaumberg, Esq., and Douglas O. Bowman, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

Conoco, Inc. (Conoco), appeals from a March 4, 1986, decision of the Director, Minerals Management Service (MMS), affirming a March 22, 1984, decision of the Chief, Royalty Valuation and Standards Division (RVSD), Royalty Management Program (RMP), MMS, setting forth the procedure to be used when calculating the transportation allowance for oil sold under Royalty-In-Kind Sale 83-1.

Conoco holds an oil and gas lease issued pursuant to section 8 of the Outer Continental Shelf Lands Act (OCSLA), as amended, 43 U.S.C. | 1337 (1982). By letter decision dated March 22, 1984, RMP notified Conoco of
the procedure to be used for claiming transportation allowances for royalty taken in-value and in-kind. The letter specifically stated that the procedure would be applied for oil taken in-kind under Royalty-In-Kind Sale 83-1. The guidelines provided:

> 1. If there is currently an MMS-approved allowance for the transportation system currently moving the RIK oil, a lessee (payor) may claim that allowance for moving RIK oil; or,
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> 2. If a lessee (payor) does not have an MMS-approved allowance for oil taken under RIK Sale 83-1, a request must be submitted no later than June 1, 1984, for a transportation allowance using the existing MMS procedure (see enclosure).

The procedure existing at the time, which was described in the enclosure was as follows:

Pipeline Allowance Formula

$$\text{Allowance per barrel or Mcf} = \frac{C + D + E}{F}$$

$$\text{or } \frac{C + (.05 \times A) + (.08 \times B)}{F}$$

A = Initial total investment

B = Undepreciated investment (A - D)

C = Annual operating costs

D = Annual depreciation (5% of A)
(Based on 20 year straight line depreciation)

E = Fair rate of return on the undepreciated investment
(8% of A, first year only, then 8% of B)

F = Annual throughput per segment

The MMS letter also advised Conoco that Conoco should disregard a January 1, 1984, draft document titled "Guideline for Applying for An Allowance for Transporting Royalty Oil Taken-In-Kind Sale 83-1" (Draft Guidelines).

By letter dated April 24, 1984, Conoco appealed the decision of the Chief, RMP, to the Director, MMS. In its notice of appeal Conoco argued that the basis for computing its transportation allowance should be the actual costs of transporting oil, including direct and indirect costs. Conoco specifically objected to element "E" of the Pipeline Allowance Formula set out above. Under the formula, Conoco could deduct a pro-rata share of an amount equal to 8-percent of its total investment the first year and 8-percent of undepreciated investment in subsequent years. The formula also provided for a straight-line depreciation at a rate of 5 percent a year. Conoco asserted that the 8-percent rate of return was arbitrary and restrictive and that the formula must take into consideration pipeline operating costs, an allowance for depreciation, and a fair rate of return on the lessee's investment in the pipeline. 1/ Conoco sought relief in the form of an amendment to the procedure to allow a fair rate of return on its investment, presumably by amending part "E" of the formula to provide for a 15-percent deduction rather than an 8-percent deduction.

On March 4, 1986, the Director issued his decision affirming the RMP determination. In his decision, the Director stated that the regulations require that producers be reimbursed for the cost of transporting royalty oil. The Director determined that in that context, a producer's transportation cost is the incremental out-of-pocket cost of transporting the oil and the formula established by RMP more than recognized appellant's entire incremental out-of-pocket expenses. Further, the Director held that a decision to include a parameter based upon return on investment is a matter within the discretion of the Department because the allowance of a deduction based upon a return of investment is not required by either the statute or the regulations. The Director noted that, although the allowance of 8 percent of the undepreciated capital investment was under review, the method of calculating the transportation allowance set out in the March 22, 1984, letter would apply. He stated that the contemplated changes were irrelevant until actually adopted. The Director noted that Conoco's transportation facilities were constructed for the primary purpose of carrying Conoco's share of the oil production to market, and transportation of the royalty oil was only incidental to Conoco's operation of the lease. Finally, he concluded:

> Under the circumstances, as regards transportation allowances, there is no requirement which would compel the inclusion of a parameter grounded on a return on undepreciated investment of Conoco's current cost of capital rates. Conoco's cost of capital at the time the transportation facilities were constructed would likewise be of purely academic interest. Accordingly, the lack of evidence in this regard has no bearing on our disposition of this appeal.

(MMS Decision at 4).

1/ Conoco also argued that it was not authorized to engage in any enterprise with a rate of return which is less than 15 percent of the cost of capital, but did not identify the entity that had imposed this restriction. We assume it was its Board of Directors.

Conoco then appealed from the Director's decision. For its first argument on appeal, Conoco contends that the pipeline allowance formula established by MMS was not promulgated pursuant to the Administrative Procedure Act (APA) (5 U.S.C. | 551 (1982)) and therefore, is not binding on the agency or on the affected lessees. Appellant asserts that the pipeline allowance formula is a legislative, substantive rule which "[m]ust meet the following three-pronged test: (1) be within the power granted to the agency; (2) be issued pursuant to proper procedure; and (3) be reasonable as a matter of due process." Appellant contends that the pipeline allowance formula fails in every respect including the reasonableness test. Conoco argues that the formula has the force and effect of law; prescribes conduct; determines entitlement; is a mandatory directive enforceable on a general and uniform basis; and sets standards for calculating transportation allowances. Conoco argues that the RMP formula, because it was not promulgated pursuant to the APA, is subject to revocation by MMS through the exercise of its own discretion.

For its second argument Conoco contends that it is required by law to market MMS' share of production and to transport that share if marketed. Conoco argues, that because of this requirement, transporting royalty oil is not merely incidental to the operation of its lease. Conoco further contends that the transportation allowance formula is arbitrary, capricious, unreasonable, and confiscatory because it does not grant a fair rate of return. Appellant suggests that a 15-percent return on investment is reasonable because it represents its current cost of capital, that is, the weighted average of the after-tax cost of debt and equity. 2/

In response, MMS contends that the Secretary of the Interior has the Congressionally granted authority and discretion to establish the value of the production from Federal oil and gas leases for royalty purposes. Further, MMS avers that where, in accordance with lease terms, royalty is taken in-value or in-kind, and the lessee provides transportation from the offshore leases to an onshore delivery point, the lessee may apply for a transportation allowance.

MMS recognizes that if the lessee pays in-kind or in-value, the transportation allowance is to be considered when determining the royalty owing. However, MMS contends that neither the OCSLA nor the applicable regulations in effect at the time prescribe a particular method by which the transportation allowance should be calculated. MMS contends that the lessee's rate of return on its investment need not be considered when setting the transportation allowance, and thus, making the rate of return a part of the transportation allowance formula is a discretionary act which is not subject to the

2/ Appellant notes that the Federal Energy Regulatory Commission (FERC) allows a higher rate of return and that the Geological Survey (GS) also permitted a higher rate of return. However, appellant has failed to provide any evidence to show that the rates used by FERC and GS represent relevant comparative figures, or that their formulae are more reasonable than the one devised by MMS.

APA and cannot be overturned absent a finding that the exercise of discretionary authority was unreasonable.

[1] Appellant first argues that the transportation allowance formula is a substantive rule and, therefore, must be promulgated pursuant to the provisions of the APA. The APA at 5 U.S.C. | 551(4) (1982) defines a
"rule" as "the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency." However, Section 553(b)(A) provides that the requirement of notice to the public of proposed rulemaking does not apply to interpretive rules, general statements of policy, or rules of agency organization, procedure, or practice.

Interpretive rules are not defined in the APA, but their meaning is distinguishable from that of a "substantive" or "legislative" rule. A substantive or legislative rule has the force of law; an interpretive rule is merely a clarification or explanation of an existing statute or rule. Guardian Federal S & L v. Federal S & L Insurance Corp., 589 F.2d 658, 664 (D.C. Cir. 1978); Cambridge Mining Co., 74 IBLA 26 (1983); see also Shell Offshore, Inc., 96 IBLA 149, 94 I.D. 69, appeal filed, No. 391-87L (Cl. Ct. July 1, 1987). Legislative rules are those that are promulgated pursuant to a congressional delegation of power to issue rules and regulations that have the force of law. American Trucking Association v. United States, 688 F.2d 1337 (11th Cir. 1982). On the other hand, a general statement of policy within the meaning of 5 U.S.C. | 553(b)(A) (1982) does not establish a binding norm; rather it leaves the administrator free to exercise his informed discretion in situations that arise. Guardian Federal S & L v. Federal S & L Insurance Corp., supra at 666.

The regulation at issue, 30 CFR 209.120 (1984), 3/ provides:

> (a) When the point of delivery for OCS royalty oil produced under a section 8 lease is to be other than on or immediately adjacent to the leased area from which the oil is produced, the small refiner/purchaser shall promptly reimburse the lessee for the cost of transporting the oil to the point of delivery. Such reimbursement shall be monthly or at such other interval as may be determined by the designated official.
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> (b) The cost of transportation shall be approved by the designated official and may be deducted from the value of the oil at the point of delivery in calculating payments to be made to the United States. The United States guarantees payments to the lessee for such cost of transportation.

3/ Subsequent to Conoco's appeal the regulations were substantially amended. See 30 CFR 206.104 and 206.105. As a result of that amendment, this case will have limited precedential value. Conoco does not contend that the regulation then in effect was not properly promulgated under the APA.

The regulation requires that small refiners and purchasers reimburse the lessee for the cost of transporting the oil. The regulation also requires approval of those costs by the designated official, in this case, the Chief, RVSD, RMP. The formula at issue is not prescribed by either the statute or regulations. It is therefore an interpretation of how the regulation is to be implemented. As such, it is within the Director's discretionary authority. Therefore, the formula may be regarded as an interpretive rule which is not subject to the notice and comment provisions of section 553 of the APA.

[2] When royalty is taken in kind and the lessee provides transportation from the offshore lease to an onshore delivery point, the lessee may apply to MMS for a transportation allowance. The courts and the Board have long considered a transportation allowance deduction to be reasonable when determining the value at the wellhead if no market exists at the wellhead (the point where the oil would ordinarily be sold and valued). United States v. General Petroleum Corp., 73 F. Supp. 225, 262-63 (S.C. Cal. 1947), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); Arco Oil & Gas Co., 109 IBLA 34 (1989); Shell Oil Co., 52 IBLA 15, 88 I.D. 1 (1981); C & K Petroleum, Inc., 27 IBLA 15 (1976); Kerr-McGee Corp., 22 IBLA 124 (1975); Shell Oil Co., 70 I.D. 393 (1963). The Secre-tary of the Interior has discretionary authority to determine the factors to be used when computing a transportation allowance for royalty purposes. Superior Oil Co., 12 IBLA 212 (1973); Shell Oil Co., supra.

The issue on appeal is not whether a transportation allowance is permitted but the reasonableness of the allowance. The allowance formula in question permits a deduction of 8-percent of the undepreciated investment in the pipeline through which the oil passes. We have examined Conoco's arguments and find that Conoco has not established that it was unreasonable to base the deduction (in part) on 8 percent of the undepreciated investment.

First, we find no basis in the Act or the regulations for Conoco's contention that, under the regulations then in effect, the transportation allowance must provide for a return on investment, let alone a return on investment equal to the cost of capital at the time the deduction is calculated (in this case 15 percent). 4/ Likewise, if Conoco's debt cost is 15 percent, as stated by Conoco, to calculate Conoco's transportation allowance based upon Conoco's cost of capital would make the general application of the transportation allowance formula problematic, and might well be a

4/ Likewise, there was nothing in the Act or the regulations then in effect to prevent MMS from adopting a higher rate of return, or, for that matter, calculating the transportation deduction based strictly on distance the oil must be transported, with no consideration of the capital cost of the pipeline. In turn, if the allowable rate of return is to be increased, an adjustment to the rate of depreciation may also be warranted. The fact that the possibilities for adjustment of the formula are endless and that any change of one factor will have a direct bearing on another further strengthens the argument that this is a discretionary decision.

basis for a claim by another producer, with lower capital costs, that the differential treatment is arbitrary. Further, the fact that FERC may permit the use of a higher rate of return for the purpose of setting tariffs has no clear relationship to the allowances considered when determining oil and gas lease royalties.

In a memorandum, dated September 25, 1984, from the Chief, RVSD, to the Chief, Division of Appeals, the Chief, RVSD, stated:

> The rate of return (ROR) used for offshore pipelines was based on ROR's from short-term notes (Treasury, 90-day notes, public utility). Local interest rates on passbook accounts were also considered. The "current" rate, 8-percent, is the result of a revision of the previous 6-percent rate about 8 years ago.

Conoco has challenged the MMS transportation allowance as unreasonable. However, Conoco has not provided any specific factual basis which would support a finding that the 8-percent rate of return was not reasonable or even that the rate of return used in the transportation allowance calculation has any direct relationship to Conoco's actual rate of return on its investment. 5/ Therefore, we must affirm the MMS determination.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Director, MMS, is affirmed.

R.W. Mullen
Administrative Judge

I concur:

C. Randall Grant, Jr.
Administrative Judge

5/ It would seem that, if we were to accept the theory urged by Conoco, it might be reasonable for MMS to demand a showing that the overall rate of return from the well in question is not more than 15 percent. The government bases its royalties on the production from the well, not the revenues from the pipeline.